United States General Accounting Office

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Report to the Commissioner of Internal Revenue

August 1999

INTERNAL REVENUE SERVICE

Serious Weaknesses Impact Ability to Report on and Manage Operations

19990811 088

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GAO/AIMD-99-196

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United States General Accounting Office
Washington, D.C. 20548

Accounting and Information Management Division

B-282549

August 9, 1999

The Honorable Charles O. Rossotti
The Commissioner of Internal Revenue

Dear Mr. Rossotti:

This report is a follow-on to our report on the results of our audit of the financial statements of the Internal Revenue Service (IRS) for fiscal year 1998.[1] Because of insufficient evidence about the reliability of fund balance with Department of the Treasury and accounts payable as well as evidence that led us to conclude that property and equipment was likely materially understated, we issued a qualified opinion on IRS' September 30, 1998, balance sheet. In addition to the balance sheet issues, insufficient evidence about nonpayroll expenses and budgetary balances also prevented us from rendering an opinion on the statements of net cost, changes in net position, budgetary resources, and financing. As we pointed out in the financial statement report and in subsequent congressional testimony,[2] pervasive weaknesses continue to exist in the design and operation of IRS' financial management systems, accounting procedures, documentation, recordkeeping, and internal controls over its administrative operations.

The matters addressed in this follow-on report relate to IRS' activities associated with its fiscal year 1998 appropriations of $7.9 billion—referred to as IRS' administrative activities. Issues relating to IRS' collection of federal tax revenue, refunding of overpayments of taxes, and unpaid tax assessments—referred to as IRS' custodial activities—are covered in a separate report. The matters in this report deal with IRS' reconciliations of fund balance with Treasury accounts, recording certain expenditures against appropriations, maintaining adequate transaction detail needed to monitor its liabilities and obligations, accounting for and controlling property and equipment, and the financial reporting process.

[1] Financial Audit: Examination of IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

[2] Internal Revenue Service: Results of Fiscal Year 1998 Financial Statement Audit (GAO/T-AIMD-99-103, March 1, 1999).

Results in Brief

Significant financial management system limitations and internal control weaknesses prevented IRS from reliably reporting on the results of its administrative activities for fiscal year 1998 and from having reliable financial information for managing its operations. These deficiencies are long-standing, many being reported in our first financial audit of IRS for fiscal year 1992. We found the following.

- Comparable to an individual reconciling his or her checkbook to a bank statement, IRS' records on its available funds should be reconciled to Treasury records monthly. However, in fiscal year 1998, IRS did not reconcile its administrative fund balance with Treasury accounts. Reconciling these accounts involves identifying differences between IRS and Treasury records, determining the reasons for the differences, and correcting them if needed. Without performing these reconciliations, IRS has no assurance that it is properly controlling and reporting its appropriated funds.
- IRS did not promptly record certain types of expenditures against appropriations. IRS' records show a net of $141 million in its suspense account at the end of fiscal year 1998 that had not been applied to a specific IRS appropriation. According to IRS' records, the absolute value of items in the suspense account related to fiscal years 1989 through 1998 totaled $238 million for government accounts and $170 million for nongovernment accounts with net values of $74 million and $67 million, respectively. Until all these transactions are posted to the proper appropriation accounts and matched with corresponding obligational records, the agency cannot ensure that the activities recorded in these accounts are proper IRS transactions and that its outstanding obligations and disbursements do not exceed appropriated amounts.
- IRS' systems were unable to generate detailed subsidiary records of its accounts payable and outstanding obligations (i.e., undelivered orders). In part this was due to IRS not having adequate transaction-level detail to match related transactions. The lack of subsidiary records for key account balances affects IRS' ability to provide meaningful and reliable financial information needed to effectively report on and manage its operations. For example, without an accounts payable subsidiary ledger, IRS cannot readily support its accounts payable balance and determine that invalid accounts payable are removed from the account. Also, without comparing outstanding amounts in its undelivered orders accounts to outstanding obligations, IRS cannot readily determine whether the amount for undelivered orders is valid.

- IRS' property and equipment was likely materially understated due to a number of deficiencies in its recording of property and equipment. IRS' financial statements do not reflect the significant assets that IRS has purchased as part of tax system modernization. For example, we found that major capital expenditures relating to IRS' mainframe consolidation and its new system to process tax returns and remittances (receipts) were not included in IRS' property and equipment account on its financial statements. Nearly 69 percent of the gross property and equipment in IRS' detailed records is not included in property and equipment on its financial statements either because the items have an individual item value of less than Treasury's $50,000 capitalization threshold and do not meet the bulk purchase capitalization threshold or because the individual component parts of major computer project purchases are not aggregated. Additionally, IRS' detailed records do not accurately keep track of additions and deletions of property and equipment. IRS itself has reported every year since 1983, under the Federal Managers' Financial Integrity Act,[3] that because it does not have a reliable system of accounting for property, it is unable to determine if property is being properly used or misappropriated.
- IRS did not have adequate review procedures to oversee and manage the accounting and financial reporting process. We found significant errors and omissions in IRS' draft financial statements involving millions of dollars and in some cases hundreds of millions of dollars, which likely would have been caught and corrected had these documents undergone appropriate review by management. For example, initially the three major budgetary accounts reflected negative available unobligated balances totaling about $200 million. Based on our inquiry, IRS performed additional analysis on these accounts and subsequently revised them to show positive available unobligated balances totaling about $50 million.

IRS has acknowledged these weaknesses and plans to improve its financial data for its administrative accounts. Past attempts to implement corrective action plans for these problems have not been effective. Although some areas, such as fund balance with Treasury reconciliations, improved as noted in our report on IRS' fiscal year 1996 financial statements, IRS again experienced problems in these areas for fiscal year 1998. To correct these weaknesses, sustained attention by senior IRS management is necessary.

[3]The Federal Managers' Financial Integrity Act requires agencies to annually report on their material weaknesses.

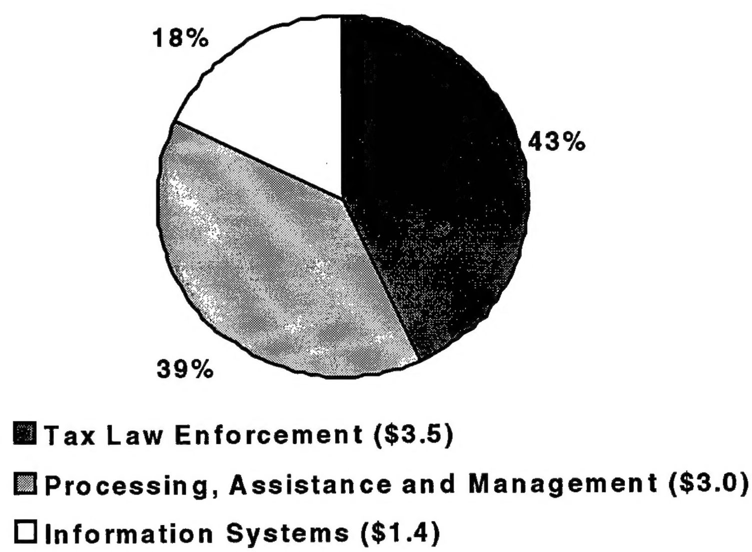
Some of these weaknesses can be addressed in the short-term by making improvements in procedures and controls. For example, the fund balance with Treasury reconciliation deficiencies can be addressed by ensuring that the reconciliations are performed monthly. While some needed improvements can be achieved in the short-term, we recognize that for other weaknesses long-term systems modernization will be needed. For example, in order to properly account for and control its property and equipment, IRS will need a fully integrated inventory and accounting system. Left uncorrected, the internal control weaknesses identified will continue to hinder IRS' ability to manage its financial operations and routinely prepare reliable and timely financial information. This report contains a number of recommendations related to these weaknesses for which IRS has begun corrective action or has agreed to take action.

Background

IRS is responsible for collecting and accounting for federal tax revenue and refunding tax overpayments. In fiscal year 1998, IRS collected almost $1.8 trillion in tax revenues, issued $151 billion in tax refunds, and had net taxes receivable at year-end of $26 billion. IRS receives the majority of its funding for its operations through annual, multiyear, and no-year appropriations that are available for use within statutory limits. These appropriations include (1) processing, assistance, and management, (2) tax law enforcement, and (3) information systems.[4] As illustrated in figure 1, for fiscal year 1998, IRS reported program expenses of $7.9 billion, including $3.5 billion for tax law enforcement, $3.0 billion for processing, assistance, and management, and $1.4 billion for information systems.

[4]These are the main appropriations related to IRS expenditures in fiscal year 1998. IRS also has other appropriations, such as technology investment, but expenditures related to these appropriations were not material in fiscal year 1998.

Figure 1: IRS' Fiscal Year 1998 $7.9 Billion of Operating Expenses by Program (Dollars in Billions)



Source: Unaudited IRS data.

Appendix I provides details on our scope and methodology and appendix II includes IRS' written comments on this report.

Over the past 6 years, we have issued various reports about weaknesses associated with IRS' administrative operations. To help IRS correct weaknesses associated with its administrative activities, we made numerous recommendations in those reports. Many of these recommendations, if effectively implemented, would help address the issues identified in this report. Appendix III summarizes both the previous years' open recommendations and the recommendations made this year.

In response to our financial statement audit report for fiscal year 1998, IRS is developing a corrective action plan to address the issues identified. We will evaluate the actions taken as part of our fiscal year 1999 audit.

IRS Efforts to Reconcile Its Fund Balance With Treasury Were Ineffective

During fiscal year 1998, IRS did not reconcile its administrative fund balance with Treasury accounts. IRS uses over 30 Treasury accounts.[5] Treasury policy and prudent financial management practices require agencies to prepare monthly reconciliations of fund balance with Treasury accounts to Treasury's records. Reconciling these accounts involves identifying differences between IRS and Treasury records, determining the reasons for the differences, and correcting them if needed. Differences arise when either IRS or Treasury incorrectly records or delays recording of deposits to and disbursements from IRS appropriation accounts. Correcting such differences should result in adjustments to either Treasury's or IRS' records, or both. This process is similar to an individual reconciling his or her checkbook to a monthly bank statement and this reconciliation should occur monthly. Without performing these reconciliations, IRS has no assurance that it is properly controlling the funds appropriated to it and that amounts are being properly recorded.

IRS' inability to reconcile its fund balance with Treasury has been reported as a problem area dating back to 1992, the first year IRS' financial statements were subject to audit. We have recommended that IRS perform prompt reconciliations, including investigating and resolving the reconciling items. As a result, IRS has implemented corrective actions in the past. For example, during our fiscal year 1996 audit, IRS, with the help of a contractor, reconciled its fund balance with Treasury accounts to Treasury's records within an immaterial amount. However, we found that IRS' reconciliation of its fund balance with Treasury accounts was not effective in fiscal year 1998.

In fiscal year 1998, IRS did not prepare monthly reconciliations of its over 30 fund balances with Treasury accounts. For fiscal year 1998, IRS officials said they relied on a contractor to reconcile IRS' fund balance with Treasury accounts. In January 1999, IRS' contractor provided what it considered to be reconciliations of IRS' fund balance with Treasury for the 12 months of fiscal year 1998. However, in addition to these reconciliations not being performed promptly, they were inadequate in that amounts on the reconciliations did not agree with Treasury's and IRS' records, and reconciling items listed were not investigated and resolved. For example, one reconciliation indicated that the general ledger balance was over

[5]The accounts include individual accounts for fiscal years 1993 through 1998 for each of IRS' three major annual appropriations—processing, assistance, and management; tax law enforcement; and information systems—as well as accounts for its other appropriations and suspense.

$3 billion, but based on our review of IRS' general ledger, the balance was $71 million. This reconciliation also reflected what appeared to be over $30 million in reconciling items that were not investigated or resolved. In another example, the reconciliation showed the Treasury balance as $662 million while Treasury's statement reflected a balance of $454 million.

Significant unreconciled amounts between Treasury's and IRS' records for fund balance with Treasury call into question the accuracy of reported amounts for operating expenses, assets, and liabilities. Also, the lack of properly prepared reconciliations affects IRS' ability to ensure that it complies with the law governing the use of its budget authority since the unresolved differences could significantly affect the status of budget authority available to be obligated and expended. For the future, it will be important for IRS to prepare these reconciliations monthly and promptly resolve any differences. Absent properly prepared reconciliations of fund balance with Treasury, this long-standing problem area for IRS will continue to negatively affect IRS' ability to produce reliable financial information and properly manage its appropriated funds.

Recommendation

We recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to ensure that IRS promptly resolves differences between IRS and Treasury records of IRS' appropriation account balances and adjusts accounts accordingly. For example, reconciliations should be performed promptly every month, with Treasury and IRS amounts in agreement and reconciling items properly resolved.

IRS Did Not Promptly Record Certain Expenditures Against Appropriations

As was the case in previous years, in fiscal year 1998, IRS did not promptly investigate and resolve amounts in its administrative suspense account. To obtain assurance that funds were actually used for the purpose appropriated and within prescribed dollar limits, agencies are required to promptly match disbursements against applicable obligations. As of September 30, 1998, IRS' records showed that the suspense account had a net outstanding balance of $141 million that had not been researched and posted to the proper appropriation account, including some items dating back to fiscal year 1989 appropriations. As shown in table 1, according to IRS' records, the absolute value of items in the suspense account related to fiscal years 1989 through 1998 totaled $238 million for government accounts and $170 million for nongovernment accounts.

Table 1: IRS' Suspense Account Components as of September 30, 1998 (Dollars in Thousands)

	Government	Nongovernment
1989	—	$8
1990	-$41	801
1991	-7	-5,686
1992	177	3,627
1993	-26	4,044
1994	117	-6,439
1995	18,294	4,290
1996	43,556	-38,950
1997	-82,125	94,277
1998	93,734	11,566
Total absolute value	$238,077	$169,688
Total net value	**$73,679**	**$67,538**

Source: Unaudited IRS data.

Until IRS researches and resolves its suspense items, it will have little assurance that the amounts recorded in this account are proper IRS transactions and that its outstanding obligations and disbursements records do not exceed appropriated amounts.

According to IRS officials, the majority of the dollar value of the suspense account is related to transactions in which another federal agency charges IRS for goods or services using Treasury's electronic bill-paying system.[6] Although we were not able to obtain a detailed list of items in the suspense account as of September 30, 1998, from IRS, we did see examples of suspense transactions during our testing of nonpayroll operating expenses. Reasons for placing items in suspense include not having received a breakdown of charges from the billing agency, not having a receipt and acceptance certification, and not having sufficient funds obligated.[7] The following are examples of items placed in suspense that were reviewed in our testing of nonpayroll operating expenses and are shown to illustrate suspense transactions. The first two examples show the length of time it

[6]IRS officials questioned the validity of the large dollar value of items categorized as nongovernment and said there appeared to be a coding error.

[7]If IRS receives an invoice for over 10 percent above the obligated amount, the transaction will be posted to suspense until additional funds are obligated.

can take for items to be cleared from suspense, and the last two examples show how items are placed in suspense due to insufficient obligation of funds.

- The General Services Administration (GSA) charged IRS $8.7 million for rent on February 18, 1998, and IRS did not clear the transaction out of suspense until May 1, 1998, after it resolved questions related to the March 23, 1998, receipt and acceptance certification.
- On November 26, 1997, GSA charged IRS about $1 million for payment of a leasehold improvement. Because documentation of receipt and acceptance had not yet been received by IRS, no expenditure was posted. Instead, the entire amount was placed into suspense pending certification of receipt and acceptance. Although the receipt and acceptance was documented on March 5, 1998, the bill was not posted to expenses until June 4, 1998, over 6 months after the GSA charge and 2 months after certification of receipt and acceptance.
- In another case, GSA charged IRS $9.2 million for telecommunications services on May 26, 1998. This $9.2 million was placed into suspense by IRS, awaiting receipt and acceptance certification and obligation of an additional $2 million. Receipt and acceptance was almost 2 months later on July 16, 1998, and the charge was finally removed from suspense on July 28, 1998, after a $2 million obligation modification.
- In another telecommunications transaction, GSA charged IRS' Treasury account for $9 million on April 23, 1998. However, the obligation for this expenditure was only $5 million. On May 29, 1998, an additional $4 million was obligated, and on June 2, 1998, the transaction was removed from the suspense account.

While IRS may have to place items in suspense while awaiting supporting documentation or obligation of funds, it is important that transactions be cleared from suspense as quickly as possible and that the suspense account be cleared at the end of the year. As shown above, some items in our sample of nonpayroll expenses were in suspense for a number of months. Since IRS was not able to give us a list of amounts in suspense as of September 30, 1998,[8] we do not know how long the items had been in suspense at that date and if there were old outstanding amounts. Transactions where sufficient funds have not been obligated are of

[8]IRS relies on a contractor to extract information from its accounting system. The contractor was still trying to prepare lists of accounts payable and undelivered orders at the end of our audit work and had not prepared a suspense list as of year-end.

particular concern because until the funds are obligated, IRS does not have an accurate picture of how it has used its budget authority. Also, to the extent that there were outstanding amounts in suspense for which obligations had not been recorded, obligations would be understated.

Until the transactions in IRS' suspense account are posted to the proper appropriation account, the agency will have little assurance that the amounts recorded in this account are proper IRS transactions and that its disbursements do not exceed appropriated amounts. In addition, IRS cannot report reliable budget information until its suspense account is cleared.

Recommendation

We recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to strengthen control over IRS' operating funds by promptly investigating and clearing suspense account items. For example, outstanding amounts in the suspense account should be reviewed every month to try to resolve and clear outstanding balances.

IRS Does Not Have Subsidiary Ledgers to Routinely Track and Monitor Its Liabilities and Obligations

IRS does not have detailed subsidiary records to support certain key account balances, including accounts payable and undelivered orders. As a result, for fiscal year 1998, as in past audits, IRS' support for its accounts payable balance continued to be inadequate. In addition, IRS' support for its undelivered orders[9] balance was inadequate for fiscal year 1998. According to Federal Financial Management Systems Requirements,[10] an agency's core financial system should be supported by a general ledger account structure that complies with the U.S. Government Standard General Ledger.[11] To support the account balances in these Standard General Ledger accounts, the general ledger should be supported by subsidiary ledgers that routinely provide data supporting account balances,

[9]Undelivered orders represent the value of goods and services ordered that have been obligated but that have not been received.

[10]These requirements are included in the Federal Financial Management Improvement Act of 1996 and are detailed in the Federal Financial Management Systems Requirements series issued by the Joint Financial Management Improvement Program, Office of Management and Budget (OMB) circular A-127, Financial Management Systems, and OMB's September 9, 1997, guidance.

[11]The U.S. Government Standard General Ledger establishes a standard chart of accounts, including account titles, definitions, and uses. Its primary purpose is to standardize federal agency accounting to support the external reports and financial statements required by OMB and Treasury, and to provide comparable information for agencies.

such as accounts payable and undelivered orders. These subsidiary ledgers would list outstanding amounts by transaction/vendor in accounts payable and undelivered orders and thus provide IRS with detailed information on its outstanding obligations. Without such information, IRS cannot routinely provide meaningful and reliable financial information needed to effectively manage and report on its operations.

For accounts payable, IRS was only able to generate a transaction history that included all transactions that had been recorded in accounts payable since 1991, including amounts that had since been paid and were therefore no longer payable. As a result, IRS cannot readily determine what its accounts payable balance consists of and what it owes money for. Accounts payable was the combination of three general ledger accounts. For the largest accounts payable account, which, according to IRS totaled $338 million as of September 30, 1998, we received a computerized list that netted to this amount. The transaction history included numerous debit and credit entries of over a billion dollars each (as shown in table 2). The entries included amounts that had been established as accounts payable and had subsequently been paid. When inputting transactions into its accounting system, IRS does not include an indicator code that would enable it to easily match offsetting entries in order to produce a list of outstanding amounts. After much manipulation, IRS provided a tape in which some of the related entries had been removed from the detailed transaction history, but IRS was not able to give us a list of outstanding accounts payable as of September 30, 1998, that could be tested for validity and completeness.

Table 2: Information on Data Tapes Provided by IRS (Dollars in Millions)

Accounts	Debits	Credits	Net value—debit (credit)
Accounts payable			
Original	$1,317	$1,655	($338)
Revised	314	658	(344)
Undelivered orders			
Original	$3,066	$4,049	($983)
Revised	473	1,458	(985)
Nonpayroll expenses			
Original	$2,211	$861	$1,350
Revised	1,677	327	1,350

Note: Revised figures are the amounts of debits and credits after offsetting entries that could be identified were eliminated. An example of offsetting entries would be the entries related to establishing an accounts payable and its subsequent disbursement.

Source: Unaudited IRS data.

Similarly, IRS could not determine the outstanding portion of amounts ordered from each of its vendors as of September 30, 1998. IRS' financial system is unable to generate a list of its outstanding obligations (i.e., undelivered orders). For example, if IRS obligates funds for a leasehold improvement to be performed by GSA, the undelivered order represents the value of services not yet performed. As of September 30, 1998, IRS reported undelivered orders, a key component of the obligations incurred line item on the Statement of Budgetary Resources, at $985 million. This amount was reported based on a detailed transaction history including initial obligations along with subsequent liquidations. IRS initially provided us with a computerized list of about $3 billion in debits and about $4 billion in credits to support its $985 million in undelivered orders as of September 30, 1998. The entries included amounts that had been obligated and subsequently liquidated. However, IRS does not include an indicator code when inputting transactions into its accounting system that would enable it to easily match offsetting transactions. As shown in table 2, after much manipulation, IRS was able to reduce the debit amounts, but IRS was not able to provide a list of outstanding undelivered orders at year-end. Knowing what the outstanding undelivered orders are, periodically reviewing them for validity, and removing invalid amounts are important in order for IRS managers to know exactly what is left of their appropriated funds.

Nonpayroll Operating Expenses

As was the case with the accounts payable and undelivered orders areas, we were also unable to obtain a list of IRS' nonpayroll operating expenses for fiscal year 1998. Instead, IRS provided us with the detailed history for nonpayroll operating expenses, which included many items that were not fiscal year 1998 expenses. The original tape to support a reported $1.3 billion of expenses included $2.2 billion in debits and $861 million in credits. We were able to identify and clear some offsetting entries but not all, as shown in table 2. Many of the debits and credits were offsetting amounts related to prior years' expenses. However, IRS did not have a data field in its accounting system that would facilitate identifying offsetting transactions. We took statistical samples to verify IRS' fiscal year 1998 nonpayroll operating expenses and found significant errors (76 of 208 transactions tested were classified as errors). For example, we found (1) property and equipment purchases and leasehold improvements that should have been capitalized, (2) transactions that related to prior years, and (3) credit entries related to prior years. As a result, we were unable to conclude that IRS' nonpayroll operating expenses for fiscal year 1998 were reliable. Since reliable expense data are the basis for providing good cost information, these problems led us to conclude that IRS is unable to provide reliable cost information or cost-based performance measures.

In addition, in our review of expenses, we identified cases of questionable cost allocation. For example, for fiscal year 1998, IRS used its appropriations categories of processing, assistance, and management; tax enforcement; and information systems to categorize costs on its net cost statement. We found that almost all rent was charged to the processing, assistance, and management category. From a financial reporting perspective, rent should be allocated to the various IRS cost categories that benefited from IRS office space.

In our March 1998 testimony[12] on IRS' fiscal year 1999 budget request, we stated that IRS included funding requests for similar activities in its tax enforcement as well as its appropriations request for processing, assistance, and management. For example, IRS requested $891.6 million for the "Telephone and Correspondence" budget activity within the processing, assistance, and management appropriation in fiscal year 1999. That activity covers all non-face-to-face contacts between IRS and taxpayers. Such contacts include typical forms of assistance, such as answering telephone

[12]Tax Administration: IRS' Fiscal Year 1999 Budget Request and Fiscal Year 1998 Filing Season (GAO/T-GGD/AIMD-98-114, March 31, 1998).

calls and correspondence, as well as several enforcement activities, such as correspondence audits and attempts to collect overdue taxes over the telephone. At the same time, however, IRS' tax law enforcement request included an unspecified amount of money for various forms of assistance, including walk-in service, taxpayer education efforts, and problem resolution. Since IRS uses its appropriation categories to categorize costs for its financial data and on its Statement of Net Costs for its financial statements, this categorization causes misclassification of costs on IRS' financial statements and will affect the validity of cost-based performance measurements.

Recommendations

To effectively manage and report on key balances, we recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to develop subsidiary records for accounts payable and undelivered orders and a list of current year nonpayroll operating expenses that will provide reliable accounts payable, undelivered orders, and nonpayroll operating expense data. This could include adding an indicator code when inputting transactions into the accounting system that will let IRS identify and eliminate offsetting transactions. In the long-term, it could include enhancements to IRS' financial systems to include the capability of routinely generating subsidiary records of outstanding accounts payable and undelivered order balances and a reliable list of current year nonpayroll operating expenses.

In addition, we recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to develop the data to support meaningful cost information categories and cost-based performance measures.

IRS Does Not Adequately Account for and Control Its Property and Equipment

IRS has historically been unable to reliably account for and control its property and equipment (P&E). Federal property management regulations specify that each agency shall establish and maintain control of personal property inventories to avoid fraud, waste, and abuse. However, IRS has itself reported deficiencies in its property management controls since 1983. In its fiscal year 1998 Federal Managers' Financial Integrity Act (FMFIA) report, IRS reported that it has material weaknesses in property management procedures and controls over the use and accountability of capitalized property. IRS also reported that without a reliable system of accounting for property, it is unable to determine if property is being properly used or misappropriated. We found that

- IRS materially understated the amount of P&E in its financial statements as of September 30, 1998, and
- IRS does not have sufficient control over its P&E due to inaccurate detailed records. In addition, IRS' P&E detailed records are not integrated with its accounting system, and there were amounts in detailed records substantially different from amounts recorded in IRS' accounting records.

IRS' Property and Equipment Is Significantly Understated

IRS does not have adequate policies and procedures in place to ensure that all P&E purchases are identified and capitalized at the appropriate cost in accordance with federal accounting standards[13] and IRS does not review its leases to determine if they meet the criteria for capitalization of leases. According to SFFAS No. 6, agencies should record as P&E all items that meet certain characteristics, such as a useful life of 2 years or more. All costs incurred to bring P&E to a form and location suitable for its intended use should be capitalized and included in the cost of the item, including the design and installation costs and the costs of externally developed software. As of September 30, 1998, IRS reported $164 million, net, of P&E on its financial statements. However, based on our review of detailed records, financial information related to IRS' computer projects, equipment expenditures, and lease agreements, IRS appears to be materially understating its P&E balance.

IRS has expended significant amounts for computer-related projects, such as its new system to process tax returns and remittances (receipts)[14] and service center mainframe consolidation. According to IRS' records, a significant portion of over $100 million in expenditures associated with these two major computer projects in fiscal year 1998 were costs incurred in acquiring computer hardware and software and preparing it for use. Information obtained from both the information systems office and from IRS' expense data in its accounting records showed that in fiscal year 1998 IRS spent over $100 million for these two systems. However, IRS showed P&E additions of only about $30 million for all equipment purchases for fiscal year 1998 and, therefore, most of the over $100 million spent for the

[13]Statement of Federal Financial Accounting Standards (SFFAS) No. 6, Accounting for Property, Plant, and Equipment (effective beginning with fiscal year 1998).

[14]This system is called the Integrated Submission and Remittance Processing System (ISRP) and processes tax returns and tax receipts received directly from taxpayers.

service center mainframe consolidation and new system to process tax returns and remittances was inappropriately expensed.

IRS' use of Treasury's $50,000 minimum capitalization threshold for individual items and a $500,000 threshold for bulk purchases of items costing more than $5,000 each[15] also contributed to IRS' understatement of P&E. Federal accounting standards allow each agency to establish its own threshold and guidance on applying the threshold to bulk purchases. However, agencies should not expense material purchases that have characteristics requiring capitalization, such as a useful life of 2 years or more. During our testing, we identified significant purchases meeting SFFAS No. 6 requirements for capitalization as P&E being charged to nonpayroll operating expenses. In our expense sample, we noted a payment of about $300,000 for 10 tape units costing about $30,000 each and a $100,000 payment for 80 personal computers costing about $1,300 each. These items were not capitalized because the expenditure did not meet the $50,000 individual capitalization threshold or the $500,000 threshold for bulk purchases.

Also, our testing of nonpayroll operating expenses included a $1.3 million payment related to the purchase of numerous computer workstations for the mainframe consolidation project. However, none of the individual pieces of equipment listed on the invoice exceeded $5,000 and thus this large (bulk) purchase of P&E was expensed. The $50,000 individual item threshold and bulk purchase threshold far exceed the cost of most of IRS' P&E items and result in a material distortion of IRS' reported P&E in its financial statements. For example, IRS reported equipment-related expenses of $339 million[16] in its fiscal year 1998 financial statements. For fiscal year 1997, only $46 million in equipment-related purchases was capitalized as P&E, while $305 million in equipment purchases was expensed.

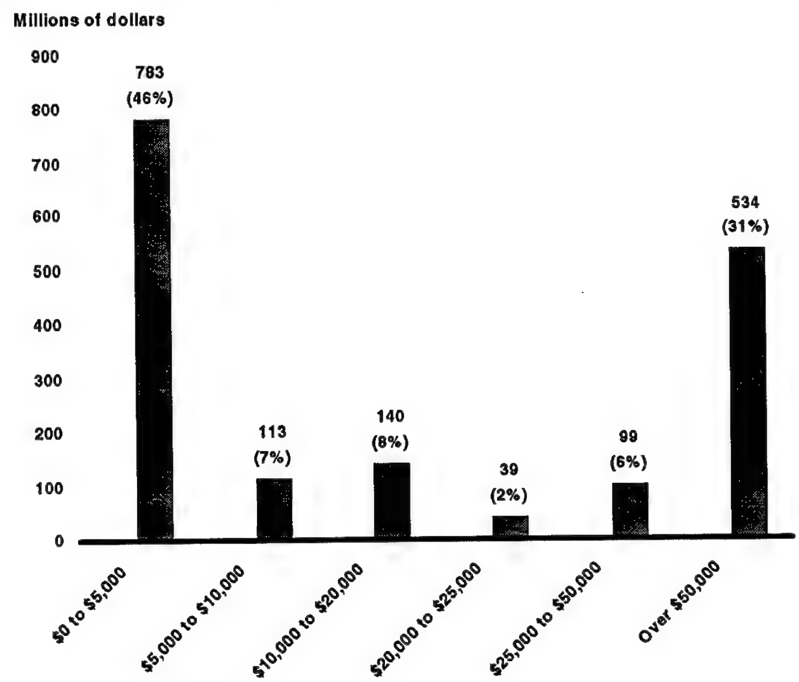
As illustrated in figure 2, we found that $1.2 billion (69 percent) of IRS' gross P&E reported in its detailed records as of September 30, 1998, was

[15]A bulk purchase of general property, plant, and equipment is the single purchase of like items in a lot (i.e., the items have the same basic utility and are composed of similar parts—furniture, automated data processing (ADP) hardware, etc.).

[16]Equipment expenses reported on the financial statements for fiscal year 1998 were $339 million, which included $100 million in depreciation and amortization expense. Equipment expenses reported on the financial statements for fiscal year 1997 included $99 million in depreciation and amortization expense.

not included in P&E in the financial statements either because the items have an individual item value of less than the $50,000 capitalization threshold and do not meet the bulk purchase capitalization threshold or because the individual component parts of major computer project purchases are not aggregated.

Figure 2: IRS' September 30, 1998, P&E Detailed Records by Individual Item Dollar Amount (Gross Amounts)



Source: Unaudited IRS data.

This analysis also reflected that about 46 percent of P&E reported in IRS' detailed records was in the $0 to $5,000 range, most of which was likely purchased in bulk. Since IRS specifies that individual items must cost at least $5,000 each to be subject to the bulk purchase threshold, 46 percent of IRS' P&E was automatically expensed. Inappropriate capitalization levels resulted in understatement of P&E on IRS' September 30, 1998, balance sheet and overstatement of nonpayroll operating expenses. Such practices distort the net cost of operations and understate assets.

We also analyzed IRS' purchases of P&E for the last 5 fiscal years[17] as shown in IRS' detailed records to determine the effect of IRS' $50,000 capitalization threshold. As shown in table 3, over the last 5 fiscal years only 33 percent of the P&E recorded in IRS' detailed records had a purchase price of over $50,000.

Table 3: IRS' P&E Purchases for Fiscal Years 1994-1998 (Dollars in Millions)

Fiscal year	P&E additions per detailed records	P&E additions over $50,000 per detailed records	Percent of additions over $50,000
1994	$207	$81	39
1995	232	76	33
1996	216	81	38
1997	150	46	31
1998	138	28	20
Total	**$943**	**$312**	**33**

Note: IRS capitalizes P&E with an acquisition amount or price equal to or above $50,000. According to our and IRS reports, IRS' detailed records are incomplete.

Source: Unaudited IRS data.

In addition, IRS did not capitalize any lease agreements in fiscal year 1998. Based on our review of IRS' detailed records, some lease agreements appear to meet the criteria in SFFAS No. 6 for capitalization. For example, in our review of mainframe consolidation costs, we identified $63.5 million that was budgeted for fiscal year 1998 that was for computer equipment and software with a 3-year lease to purchase. This would appear to meet the criteria for capitalization. IRS officials told us that IRS did not evaluate leases to determine whether any leases met the P&E capitalization criteria.

IRS will be incurring major expenditures to modernize its tax systems and it will be important for IRS to properly account for these expenditures as they are made. In December 1998, IRS awarded its prime contract for tax systems modernization. IRS is partnering with the private sector to make technology investments in its primary business lines: customer service, compliance, electronic commerce, submission processing, corporate systems, and financial reporting. As these investments are made, SFFAS

[17]IRS depreciates a majority of its P&E over a maximum of 5 years. Therefore, all P&E over 5 years old would have a zero net value on the financial statements.

No. 6 calls for capitalizing the cost of externally developed computer systems, including software. Unless IRS changes its practices, most of these capital costs will not be captured as IRS' P&E given IRS' capitalization threshold and recognition practices. Thus, IRS' financial statements will not reflect the significant assets that IRS has purchased as part of tax system modernization.

Controls Over Inventory Records are Weak

As previously reported by us,[18] IRS internal auditors, and IRS itself, IRS' controls over its detailed records are not adequate to ensure that these records provide a reliable record of P&E assets. For example, we found that IRS did not accurately keep track of additions and deletions of P&E in fiscal year 1998. In addition, our work and that of IRS' internal auditors raised questions about the accuracy of property valuation in IRS' detailed records.

IRS relies entirely on its detailed records and an annual analysis of leasehold improvements to determine its amount of P&E. IRS maintains its detailed records in the Integrated Network and Operations Management System (INOMS) for computer-related P&E and the Property Asset Tracking System (PATS) for noncomputer-related P&E. Although IRS uses a $50,000 threshold for financial reporting, IRS' offices track P&E in detailed records using a much lower dollar threshold.

IRS has several requirements for how physical inventories of property should be performed. For example, IRS' ADP Property Management Procedural Guide calls for conducting physical inventories annually. IRS' fiscal year 1998 procedures governing non-ADP P&E require that a physical inventory to verify the existence and accuracy of property be taken at regular intervals, but in no case should the interval exceed 3 years. IRS has established procedures whereby each year, one-third of the non-ADP property should be inventoried in order to complete a 100-percent inventory every 3 years. IRS' internal audit reported that these procedures are not always being followed and, as discussed below, IRS' detailed records are inaccurate.

During our audit of IRS' fiscal year 1998 financial statements, we tested the reliability of IRS' detailed records by physically verifying the existence of

[18] Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

selected property items. These limited tests, as well as IRS internal audit reports and the results of IRS' own inventories, showed that IRS' detailed records were substantially in error. Many of the equipment items on-hand were not included in the detailed records, items that were no longer in IRS' possession had not been removed from the records, and information on other items included in the records were inaccurate, as the following examples illustrate.

- We found that 10 of 141 items (7 percent) we selected from the floor of IRS' field offices were not included in IRS' detailed records, including items such as a front-end loader, electric pallet jacket, television, facsimile machine, and a video cassette recorder.
- IRS was unable to locate 10 of the 153 (7 percent) items we selected for review from IRS' detailed records, including items such as a 1993 Chevrolet Blazer motor vehicle, a laptop computer, a workstation, a microcomputer, and a laser printer which, according to IRS' records, cost over $300,000. After performing additional follow-up, IRS was able to determine that the Chevrolet Blazer was leased from GSA in May 1993, and subsequently returned in July 1998 at the expiration of the lease agreement. However, IRS had not updated its property records to show that it no longer had the Blazer.
- IRS assigned costs ranging from $300,000 to $1,000,000 to substantially identical mail sorting machines.
- For 15 of 294 items, IRS' detailed records contained inaccurate data related to barcodes, serial numbers, manufacturer, and model numbers.

At one office in which we observed IRS staff conducting physical inventories where they attempted to trace from IRS' detailed records to the floor, IRS staff were unable to locate 19 of 130 computer equipment assets (15 percent), which cost over $50,000 each. In addition, 20 of 443 items (5 percent) that they attempted to trace from the floor were not included in IRS' detailed records. At a different office, we found that 11 of 12 items (92 percent) over $50,000 had been disposed of but had not been removed from the detailed records.

IRS' internal auditors have reported significant weaknesses in IRS' control over its P&E as illustrated in the following examples.

- In February 1999,[19] the Office of Treasury Inspector General for Tax Administration reported that a significant amount of telecommunications equipment sampled from the floor of IRS sites could not be located on the corresponding detailed records. At the Tennessee Computing Center, only 4 of 27 telecommunications equipment items identified as physically existing were actually recorded by IRS in INOMS. At the Cleveland Customer Service site, only 6 of 55 items were appropriately recorded in IRS' detailed records.
- In April 1998,[20] IRS' Internal Audit reported that P&E inventory procedures for computer equipment and software were not effective for maintaining an accurate inventory or consistently followed by all districts in the Northeast Region. For example, an inventory that was to be performed for all computer hardware and certain related software was not carried out by all districts in the region as some districts were unaware of the requirement. Also, a procedure to update the property system to reflect the relocation of computer equipment was flawed, resulting in the potential for an inaccurate inventory.

The accuracy of IRS' detailed records is especially important because IRS uses these records to determine the amount to record as P&E on its financial statements. This is because IRS inappropriately expenses all P&E purchases and then once a year computes its ending P&E balance based on its detailed records. The detailed records are maintained by IRS' field offices, which record individual property acquisitions and dispositions in the detailed records throughout the year. Since IRS' detailed records are not integrated with its general ledger accounting system, IRS is compelled to manually adjust the general ledger P&E account to force it to agree to its detailed records. To determine the amount of P&E to record on its financial statements, IRS summarizes information from its detailed records on assets with individual item dollar values of $50,000 or more. IRS then adjusts P&E and nonpayroll operating expenses in its accounting records. In making these adjustments, IRS attempts to eliminate from its expenses the P&E additions for the fiscal year. However, no analysis is done to ensure that the detailed records are complete and agree with the dollar amounts in the accounting records. As shown in table 4, the amount of P&E

[19] Review of the Internal Revenue Service's Year 2000 Efforts to Inventory Telecommunications and Commercial Off-the-Shelf Products (Office of Treasury Inspector General for Tax Administration Audit Report No. 092402, February 10, 1999).

[20] Review of INOMS Controls for the Century 2000 Initiative in the Northeast Region (IRS Internal Audit Report No. 681803, April 24, 1998).

acquired each year according to the detailed records has been much less than the amount shown under equipment-related purchases in IRS' financial statements.

Table 4: Differences in Accounting and Detailed Records for P&E Expensed for Fiscal Years 1996-1998 (Dollars in Millions)

Fiscal year	P&E expensed per accounting records	P&E expensed per detailed records	Difference in accounting and detailed records
1996	$311	$216	$95
1997	305	104	201
1998	339	111	228
Total	**$955**	**$431**	**$524**

Note: IRS expensed P&E with an acquisition amount or price below $50,000 for fiscal years 1997 and 1998. Depreciation and amortization expenses of $99 million (fiscal year 1997) and $100 million (fiscal year 1998) were not deducted from the reported equipment expense amounts of $305 million (for fiscal year 1997) and $339 million (for fiscal year 1998), because we could not break out amortization from depreciation expense. According to our and IRS reports, IRS' detailed P&E records are incomplete.

Source: Unaudited IRS data.

Recommendations

We recommend that IRS develop and implement procedures and controls to ensure that detailed P&E records are accurately maintained. These procedures and controls would include ensuring that physical inventories at field locations are effectively performed, including prompt resolution of discrepancies found in the inventories and appropriate adjustment of detailed records.

Because of inaccuracies in existing detailed P&E records and in order to provide an accurate starting point, we recommend that the Commissioner of Internal Revenue consider directing that a physical inventory of P&E be performed with adjustments being made to IRS' detailed records accordingly. To ensure that such efforts are not wasted, IRS first needs to establish and implement effective procedures to ensure that the accuracy of detailed P&E records, once corrected, is maintained.

In conjunction with or shortly after a physical inventory, we recommend that the Commissioner of Internal Revenue direct that a systematic validation of the P&E amounts (valuation) for items in IRS' detailed records be performed.

To address the likely understatement of reported P&E and improve the accuracy of information contained in the P&E records, we recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to

- develop a means to capture and capitalize all costs incurred to bring P&E to a form and location suitable for its intended use in accordance with SFFAS No. 6, including the design and installation costs and the costs of externally developed software,
- revise the current capitalization policy to ensure that material P&E acquisitions are not expensed, and
- review all lease agreements to determine whether they meet the criteria for capital leases and capitalize and properly record any leases that meet the criteria.

In the long-term, to address the system deficiencies affecting IRS' ability to effectively manage and report on its P&E balances, we recommend that the Commissioner of Internal Revenue direct that enhancements be made to IRS' financial systems to include recording P&E and capital leases as assets when purchased and to generate detailed records for P&E that reconcile to the financial records.

Financial Reporting Process Is Inadequate

We found that IRS' general ledger for administrative activities cannot routinely generate reliable and prompt financial information. IRS' basic approach to preparing its financial statements was designed specifically for the narrowly defined purpose of preparing auditable amounts and balances only at fiscal year-end. Also, one of the significant challenges facing IRS involves establishing a financial management team with sufficient expertise to ensure that reliable financial information is produced. In order to improve financial management, it will take both a sustained commitment by top management and a sound support team.

IRS relies on various costly and time-consuming ad hoc procedures and adjustments to prepare its financial statements at year-end. These include adjustments for P&E and leasehold improvements and numerous other adjustments made at year-end. Therefore, information to measure results is not available throughout the year as a management tool to aid managers in fulfilling their responsibilities for evaluating performance.

For fiscal year 1998, adequate supervision of the financial reporting process did not occur. Key financial management positions went unfilled and review of financial and accounting entries was lacking or ineffective.

For the preparation of IRS' fiscal year 1998 financial statements, there was heavy reliance on contractor support to provide the supporting data for the financial statements without necessary supervision and involvement by IRS personnel. The Comptroller General's standards for internal controls[21] require supervisors to continuously review and approve the assigned work of their staffs. However, this did not occur at IRS for fiscal year 1998. These deficiencies contributed to IRS' inability to adequately support most of its administrative accounts for its financial statements leading to disclaimers of opinions for four financial statements and a qualified opinion on its balance sheet. Several of the deficiencies noted in this report resulted from inadequate supervision over the accounting and financial reporting functions, as the following examples illustrate.

- As discussed above, reconciliations of fund balance with Treasury were not prompt or successful for fiscal year 1998. The schedules provided to us, which were purported to be reconciliations, came directly from IRS' contractors with no IRS review. Consequently, we believe that IRS did not provide adequate oversight of the contractors to ensure that the reconciliations were properly and promptly performed.
- Key personnel with responsibilities for financial systems and reporting on IRS' administrative activities had left IRS by July 1998 and had not been replaced by year-end. For example, the Financial Applications Support & Technology and Financial Systems section chiefs left IRS and were not replaced by February 1999. Also, the head of the Accounting Standards & Evaluation Division transferred to a field office in fiscal year 1998. Consequently, IRS was compelled to prepare its financial statements without managers to properly oversee and review them, as well as perform supervisory review on post-closing adjusting and reclassification entries.
- Due to the implementation of new federal accounting and reporting requirements, IRS prepared four new financial statements, including the Statements of Budgetary Resources and Financing. The accountant responsible for preparing these budgetary statements had written guidance issued only by Treasury and OMB to assist in preparing the statements. There was little to no supervisory input provided to the accountant preparing the statements nor did the statements undergo a detailed review prior to being issued in draft. Consequently, throughout our review of the draft statements, we found numerous errors and omissions, which should have been caught and corrected had these

[21]Standards for Internal Controls in the Federal Government, U.S. General Accounting Office, 1983.

statements been appropriately reviewed by management. For example, in several drafts of IRS' financial statements, the three major budgetary accounts reflected negative available unobligated balances totaling about $200 million. A negative balance could indicate the possibility of an Anti-Deficiency Act violation. IRS officials told us that IRS did not violate the Anti-Deficiency Act and had it performed a more comprehensive review, it would have corrected this error prior to providing us its draft financial statements. Based on our inquiry, IRS performed additional analysis on these accounts and subsequently revised its balances to show available unobligated balances totaling about $50 million.[22] Even after these adjustments, we were unable to determine if the revised balances in these accounts were reliable. Table 5 shows the draft and final numbers for unobligated balances available as of September 30, 1998.

Table 5: Unobligated Balances Available as of September 30, 1998 (Dollars in Millions)

Appropriation	December 15, 1998 draft of financial statements	Final financial statements
Processing, assistance, and management	-$23	$8
Tax law enforcement	-22	4
Information systems	-148	34
Other	311	318
Total	**$118**	**$364**

Note: IRS received an appropriation of $295 million for information technology investments. However, these funds were not available for obligation until September 1, 1998, and were not obligated as of September 30, 1998.

Source: Unaudited IRS data.

- During fiscal year 1998, a large number of post-closing adjusting and reclassification entries were made to correct erroneous entries and balances in the accounting records. For example, we questioned the reasonableness of the downward adjustment account and upward adjustment account of prior year undelivered orders, which were each larger than the beginning balance of undelivered orders of $668 million.

[22]Note that we did not give an opinion on IRS' Statement of Budgetary Resources or test compliance with the Anti-Deficiency Act due to limitations on the scope of our work.

Based on our inquiry, IRS identified about $580 million worth of transactions that were inappropriately included in each of these adjustment accounts, as shown in table 6.

Table 6: Upward and Downward Adjustments of Undelivered Orders (Dollars in Millions)

	Upward adjustments	Downward adjustments
Original balance	-$683	$727
Per IRS, transactions inappropriately included	581	-577
Revised balance	-$102	$150

Source: Unaudited IRS data.

IRS subsequently reduced each of these adjustment accounts by about $580 million. Since these accounts are included in five separate line items in the Statement of Budgetary Resources, these errors would have significantly understated some line items while overstating others, resulting in a material distortion of the financial statement. Even after these adjustments, however, we were unable to determine if the revised balances in these accounts were reliable because we were not able to obtain a list of outstanding undelivered orders at the beginning or end of the year.

Recommendations

IRS can improve its financial reporting process by ensuring that appropriate supervisory and management review of its financial statements and operations occurs. We recommend that the Commissioner of Internal Revenue direct that additional knowledgeable staff are employed or that existing staff are appropriately cross-trained to be able to develop IRS' financial statements and perform its accounting and financial functions or are able to perform the necessary supervision needed to obtain reliable and supportable financial data on time.

Also, to address IRS' deficiencies in its accounting and financial reporting processes, we recommend that the Commissioner of Internal Revenue direct the Chief Financial Officer to establish procedures for the financial statements to undergo review at the appropriate levels within the Chief Financial Officer's office, with documented evidence of the reviews.

Agency Comments and Our Evaluation

IRS said it agreed for the most part with the conclusions in this report. IRS said it has already begun implementing many actions to improve its administrative financial operations. For example, IRS said that subsequent to the completion of the fiscal year 1998 financial statement audit, IRS put in place an entirely new management team on the administrative accounting side. IRS noted, however, that several of the issues raised in this report will require fixing and/or replacing the current accounting system as well as integration with the other administrative systems (e.g. procurement, property, and personnel) and cannot be fixed in the short-term.

We are pleased to see that IRS has begun taking positive steps towards addressing the recommendations in this report in order to improve its administrative accounting such as hiring needed supervisory personnel. However, it will take sustained senior management attention to resolve IRS' weaknesses in its administrative accounting area.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations. You should send your statements to the Senate Committee on Governmental Affairs and the House Committee on Governmental Reform and Oversight within 60 days after the date of this report. A written statement also must be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

We are sending copies of this report to Senator Ted Stevens, Senator Robert Byrd, Senator Ben Nighthorse Campbell, Senator Byron Dorgan, Senator William Roth, Senator Daniel P. Moynihan, Senator Orrin Hatch, Senator Max Baucus, Senator Fred Thompson, Senator Joseph Lieberman, Senator Pete Domenici, Senator Frank Lautenberg, Representative Bill Young, Representative David Obey, Representative Jim Kolbe, Representative Steny Hoyer, Representative Bill Archer, Representative Charles Rangel, Representative Dan Burton, Representative Henry Waxman, Representative Stephen Horn, Representative Jim Turner, Representative John Kasich and Representative John Spratt in their capacities as Chair or Ranking Minority Member of Senate and House Committees and Subcommittees. We are also sending copies to the Honorable Lawrence H. Summers, Secretary, Department of Treasury; the Honorable Jacob J. Lew,

Director, Office of Management and Budget, and other interested parties. Copies will be made available to others upon request.

Please contact me at (202) 512-3406 or Joan Hawkins at (202) 512-8433 if you have any questions concerning this report. Other key contributors to this report are listed in appendix IV.

Sincerely yours,

Gregory D. Kutz

Gregory D. Kutz
Associate Director
Governmentwide Accounting and Financial Management Issues

Contents

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Abbreviations

ADP	automated data processing
FMFIA	Federal Managers' Financial Integrity Act
GSA	General Services Administration
INOMS	Integrated Network and Operations Management System
IRS	Internal Revenue Service
OMB	Office of Management and Budget
P&E	property and equipment

Scope and Methodology

As part of our audit of IRS' fiscal year 1998 financial statements, we conducted an evaluation of IRS' internal controls. We designed our audit procedures to test relevant controls and included tests for proper authorization, execution, accounting, and reporting of transactions. Some of the key procedures we performed included the following.

- We selected a statistical sample of nonpayroll operating expense transactions and traced sample information to supporting documentation, such as invoices, receiving reports, and obligating documents, and reconciled total expense transaction data to the general ledger and the financial statements.
- We selected a statistical sample of payroll operating expense transactions and traced sample information to supporting documentation, such as time and attendance records and personnel folders, conducted analytical procedures on year-end payroll expenses, and obtained documentation to support IRS personnel liabilities from other federal agencies, such as the Department of Labor.
- We conducted site visits to confirm the physical existence of a nonrepresentative selection of property and equipment at several IRS service centers and other IRS locations. We also selected items at these locations and traced them to IRS' records to ensure completeness.
- We observed selected property and equipment inventories taken by IRS.
- We reviewed IRS' contractor-provided reconciliations of the fund balance with Treasury.

To assess the reliability of budget information presented in IRS' financial statements, we planned to use a combination of detail testing, analytical procedures, and where applicable, rely on our work performed in the property and equipment, accounts payable, and operating expenses areas. However, IRS was unable to provide us with the necessary data from which to select our samples due to IRS' lack of subsidiary ledgers, and thus we were unable to perform the detail tests. Also, due to deficiencies identified in our work in a number of areas such as P&E, accounts payable, and nonpayroll operating expenses, we were unable to determine whether the corresponding budgetary balances were materially correct. We performed our work from July 1998 through March 1999 in accordance with generally accepted government auditing standards and OMB Bulletin 98-08.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DEPUTY COMMISSIONER

July 14, 1999

Mr. Jeffrey C. Steinhoff
Acting Assistant Controller General
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Steinhoff:

Thank you for the opportunity to comment on the GAO Draft Report entitled "IRS: Serious Weaknesses Impact IRS' Ability to Reliably Report and Manage Its Operations." We have reviewed the findings and recommendations and agree for the most part with the conclusions of the auditors. However, we would like to point out numerous efforts which the IRS has undertaken toward improving the situation and believe that the GAO needs to include this information in order to present a more balanced picture of the IRS' administrative financial operations.

Subsequent to the completion of the FY1998 Financial Statement Audit, the IRS has put in place an entirely new management team on the administrative accounting side. This includes a new Chief Financial Officer (CFO), a new Deputy CFO, selection of a permanent Director over the Systems and Accounting Standards Division, and selection of highly qualified individuals for all five Office Chief positions serving in the administrative accounting area. We are also now in the process of filling numerous vacancies in the Division as well.

Several of the issues raised in the report will warrant fixes to and/or replacement of the current accounting system as well as integration with the other administrative systems, e. g., procurement, property, and personnel. These types of issues cannot be fixed in the short term and will require business systems planning with a view toward a more enterprise-wide system in the future. Previously the administrative functions were not part of the modernization planning efforts. With the appointment of a new Division Information Officer, Management and Financial Systems, we have an executive who is coordinating the many activities needed to define modernization systems planning and implementation efforts for administrative functions. Management and Finance is now included in the Business Systems Planning efforts to ensure inclusion of administrative needs on a par with the business needs.

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With regard to the property area, we believe this will be a long-term issue with the IRS. We have employed a highly reputable public accounting firm to assist us in getting a handle on what we can do in the short term to arrive at a reasonable valuation. Long-term plans involve a complete reengineering of the inventory process. This effort will be tasked under the Prime contract. The Prime serves as the overall systems integrator for all modernization activities.

We look forward to working with you in the future to improve the management and operation of the Service's administrative financial activities. Should you have any questions regarding this letter, please contact me or feel free to have your staff contact Lisa Fiely, Acting Chief Financial Officer, at (202) 622-6410.

Sincerely,

Bob Wenzel
Deputy Commissioner Operations

Status of GAO Recommendations on IRS Administrative Activities

As a result of our financial audits of IRS from fiscal years 1992 through 1996, we made a total of 29 recommendations for improving IRS' administrative accounting and internal controls. Action was completed on 15 of these recommendations as of the end of the fiscal year 1996 administrative financial statement audit, and thus these recommendations were closed. In fiscal year 1997, IRS' administrative activities were audited by the Department of the Treasury Office of Inspector General.[1]

The following table shows the updated status of the 14 prior administrative accounting and internal control recommendations that were still open at the completion of the fiscal year 1996 audit, numbered 1-14 in the table. We also have added new recommendations we are making in this report as a result of our fiscal year 1998 audit. They are numbered 15-27 in the following table.

Table III.1: Status of Open GAO Recommendations on IRS Administrative Activities

Report	Administrative recommendations	Description of recommendations
Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993)		
	1. Develop and implement standard operating procedures that incorporate controls to ensure that detailed records are accurately maintained. Such controls should include (1) establishing specific procedures to ensure the prompt and accurate recording of acquisitions and disposals in IRS' ADP fixed asset system, including guidance addressing the valuation of previously leased assets, (2) reconciling accounting and detailed records monthly as an interim measure until the successful integration of inventory and accounting systems is completed as planned, and (3) implementing mechanisms for ensuring that annual physical inventories at field locations are effectively performed, that discrepancies are properly resolved, and that detailed records are appropriately adjusted.	We are closing this recommendation and replacing it with recommendations 19, 20, 21, and 25 to highlight the need for action.
	2. Oversee efforts for ensuring that P&E inventory data, including telecommunications and electronic filing equipment, are complete and accurate.	Open.
	3. Determine what information related to ADP resources, such as equipment condition and remaining useful life, would be most useful to IRS managers for financial management purposes and develop a means for accounting for these data.	Open.

[1]See Internal Revenue Service Accountability Report Fiscal Year 1997, Department of the Treasury (March 1998).

Report	Administrative recommendations	Description of recommendations
	4. Develop an interim means to capture relevant costs related to in-house software development.	Open. Beginning with fiscal year 2001, agencies will be required to implement the provisions of SFFAS No.10, Accounting for Internal Use Software.
Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994)		
	5. Promptly resolve differences between IRS and Treasury records of IRS' cash balances and adjust accounts accordingly.	We are closing this recommendation and replacing it with recommendation 15 to highlight the need for action.
	6. Promptly investigate and record suspense account items to appropriate accounts.	We are closing this recommendation and replacing it with recommendation 16 to highlight the need for action.
	7. Perform periodic reviews of obligations, adjusting the records for obligations to amounts expected to be paid and removing expired appropriation balances from IRS records as stipulated by the National Defense Authorization Act for Fiscal Year 1991.	Open. IRS informed us that it has taken corrective action to address this recommendation. We will evaluate the actions taken as part of our fiscal year 1999 audit.
	8. Revise procedures to incorporate the requirements that accurate receipt and acceptance data on invoiced items be obtained prior to payment and that supervisors ensure that these procedures are carried out.	Open. IRS informed us that it has taken corrective action to address this recommendation. We will evaluate the actions taken as part of our fiscal year 1999 audit.
	9. Revise document control procedures to require IRS units that actually receive goods or services to promptly forward receiving reports to payment offices so that payments can be promptly processed.	Open. IRS informed us that it has taken corrective action to address this recommendation. We will evaluate the actions taken as part of our fiscal year 1999 audit.
	10. Use the Automated Financial System's enhanced cost accumulation capabilities to monitor and report costs by project in all appropriations.	Open.
	11. Require payment and procurement personnel, until the integration of the Automated Financial System and the procurement system is completed as planned, to periodically (monthly or quarterly) reconcile payment information maintained in the Automated Financial System to amounts in the procurement records and promptly resolve any discrepancies.	No action planned. In fiscal year 1996, IRS officials stated that IRS did not plan to manually reconcile its existing procurement and payment systems as an interim measure since they expected to integrate the procurement system with the Automated Financial System. These officials believed that this new system would ensure that payment amounts recorded in the procurement and accounting systems are equal. During our fiscal year 1999 audit, we will determine if the issue has been adequately addressed.
Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994)		
	12. Establish a method to continuously monitor and correct actions to ensure that progress is achieved.	Open.
	13. Develop reliable detailed information supporting reported accounts payable balances.	We are closing this recommendation and replacing it with recommendation 17 to highlight the need for action.

Report	Administrative recommendations	Description of recommendations
	14. Use current information to periodically update estimated future Tax Systems Modernization costs.	Open.
Financial Management: Serious Weaknesses Impact Ability to Report on and Manage Operations (GAO/AIMD-99-196, August 9, 1999)		
	15. Promptly resolve differences between IRS and Treasury records of IRS' appropriation account balances and adjust accounts accordingly. For example, reconciliations should be performed promptly every month, with Treasury and IRS amounts in agreement and reconciling items properly resolved.	We are making this recommendation, which replaces recommendation 5, to highlight the need for action on this long-standing problem area.
	16. Strengthen control over IRS' operating funds by promptly investigating and clearing suspense account items. For example, outstanding amounts in the suspense account should be reviewed every month to try to resolve and clear outstanding balances.	We are making this recommendation, which replaces recommendation 6, to highlight the need for action on this long-standing problem area.
	17. Develop subsidiary records for accounts payable and undelivered orders and a list of current year nonpayroll operating expenses that will provide reliable accounts payable, undelivered orders, and nonpayroll operating expense data.	New recommendation. This recommendation relates to recommendation 13, which we are closing.
	18. Develop the data to support meaningful cost information categories and cost-based performance measures.	New recommendation.
	19. Develop and implement procedures and controls to ensure that detailed P&E records are accurately maintained. These procedures and controls would include ensuring that physical inventories at field locations are effectively performed, including prompt resolution of discrepancies found in the inventories and appropriate adjustment of detailed records.	We are making this recommendation, which replaces recommendation 1, to highlight the need for action on this long-standing problem area.
	20. Consider directing that a physical inventory of P&E be performed with adjustments being made to IRS' detailed records accordingly. To ensure that such efforts are not wasted, IRS first needs to establish and implement effective procedures to ensure that the accuracy of detailed P&E records, once corrected, is maintained.	New recommendation. This recommendation relates to recommendation 1, which we are closing.
	21. In conjunction with or shortly after a physical inventory, perform a systematic validation of the P&E amounts (valuation) for items in IRS' detailed records.	New recommendation. This recommendation relates to recommendation 1, which we are closing.
	22. Develop a means to capture and capitalize all costs incurred to bring P&E to a form and location suitable for its intended use in accordance with SFFAS No. 6, including the design and installation costs and the costs of externally developed software.	New recommendation.
	23. Revise the current capitalization policy to ensure that material P&E acquisitions are not expensed.	New recommendation.
	24. Review all lease agreements to determine whether they meet the criteria for capital leases and capitalize and properly record any leases that meet the criteria.	New recommendation.
	25. Make enhancements to IRS' financial systems to include recording P&E and capital leases as assets when purchased and to generate detailed records for P&E that reconcile to the financial records.	New recommendation. This recommendation relates to recommendation 1, which we are closing.

Report	Administrative recommendations	Description of recommendations
	26. Ensure that additional knowledgeable staff are employed or that existing staff are appropriately cross-trained to be able to develop IRS' financial statements and perform its accounting and financial functions or are able to perform the necessary supervision needed to obtain reliable and supportable financial data on time.	New recommendation.
	27. Establish procedures for the financial statements to undergo review at the appropriate levels within the Chief Financial Officer's office, with documented evidence of the reviews.	New recommendation.

GAO Contacts and Staff Acknowledgments

GAO Contacts

Greg Kutz, (202) 512-3406
Joan Hawkins, (202) 512-8433

Acknowledgments

In addition to those named above, Christina Beck, Craig Feight, David Fisher, Paul Foderaro, Mai Nguyen, Ruth Sessions, and Keith Thompson made key contributions to this report.

Related GAO Products

Financial Audit: IRS' Fiscal Year 1998 Financial Statements (GAO/AIMD-99-75, March 1, 1999).

Financial Audit: Examination of IRS' Fiscal Year 1996 Administrative Financial Statements (GAO/AIMD-97-89, August 29, 1997).

Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996).

Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995).

Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994).

Financial Management: IRS Does Not Adequately Manage Its Operating Funds (GAO/AIMD-94-33, February 9, 1994).

Financial Management: IRS Lacks Accountability Over Its ADP Resources (GAO/AIMD-93-24, August 5, 1993).

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